March 2018

Monthly Investment Overview

MelvilleDouglas
A Member of Standard Bank Group

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Market Performance %

Equities		FEB	YTD	12M
Global	FTSE All World TR Net (Sterling)	-1.1%	-0.6%	7.3%
	FTSE All World TR Net (US dollar)	-4.2%	1.2%	18.8%
UK	FTSE All-Share TR	-3.3%	-5.1%	4.4%
US	S&P 500 TR	-3.7%	1.8%	17.1%
Europe	Dow Jones Euro STOXX TR	-3.8%	-0.7%	10.1%
Fixed Income				
Bloomberg Barclays Series -E UK Govt 1-10 Yr Bond Index		0.0%	-1.2%	-1.5%
Bloomberg Barclays Series -E US Govt 1-10 Yr Bond Index		-0.3%	-1.3%	-0.5%
JP Morgan Global Government Bond (Sterling)		2.5%	-1.2%	-4.2%
JP Morgan Global Government Bond (US dollar)		-0.7%	0.6%	6.1%
Iboxx Sterling Corporates Total Return Index		-1.2%	-1.9%	1.4%
Iboxx US Dollar Corporates Total Return Index		-1.5%	-2.4%	2.1%
Currency vs. Sterling				
US Dollar		3.2%	-1.8%	-10.0%
Euro		1.3%	-0.2%	3.7%
Yen		5.6%	3.7%	-4.9%
Currency vs. US dollar				
Euro		-1.8%	1.6%	15.3%
Yen		2.3%	5.6%	5.7%

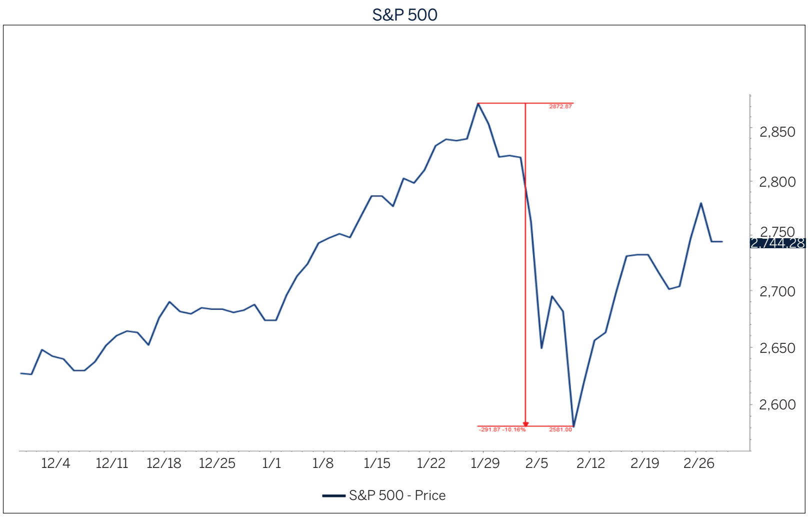
Investment Environment

The world economy has not been this strong and synchronised since the global financial crisis, but after suffering the first monthly pullback in a year at the end of February investors should expect more volatility in financial markets as the tug-of-war between economic growth and higher interest rates plays out.

In this climate, diversification is essential with the recent bout of volatility in equity markets also serving as a timely reminder for investors to keep a close eye on valuations.

The US economy has certainly been leading the way until now, with levels of unemployment well below the projected longer-run natural rate. The rest of the world has caught up, with economists revising their growth outlook higher. Europe is likely to grow faster than the US this year. As a result Global GDP is expected to grow above-trend this year and potentially again in 2019. Recently enacted tax legislation has contributed to the lift in consumer and business confidence in the US, as this is usually associated with strong economic growth. Companies have been guiding profits higher and another year of double digit earnings per share growth is expected worldwide.

This begs the question as to what caused the recent sharp correction in equity markets. The S&P500, contracted by 10% from peak to trough, as illustrated below, and global markets followed to varying degrees.



Source: Factset Research System

> "The increase in inflation, albeit from low levels, should not be a surprise given the backdrop of improving global growth, higher commodity prices and a depreciating dollar."

Higher US inflation has been cited as one of the possible reasons. Wage growth and core inflation came in stronger than expected and raised renewed fears that the Federal Reserve (Fed) might be forced to increase interest rates faster than had previously been forecast to prevent the economy from overheating. The increase in inflation, albeit from low levels, should not be a surprise given the backdrop of improving global growth, higher commodity prices and a depreciating dollar.

Although inflation expectations have been moving gradually upwards, long-term inflation expectations in the US have been anchored around 2%, a level with which the Fed would be comfortable. Their preferred measure of inflation is still relatively low (see chart below), but importantly they expect the pick-up in inflation to be "somewhat faster than 2017". Companies tend to benefit from modest levels of inflation when the economy expands, and demand improves, resulting in revenue growth and favourable profit margins. It is also interesting that many companies have used the windfall from lower taxes to announce one-off payments to employees instead of increasing wages and that certain companies have indicated that they would use the boon to strengthen their competitive position by lowering prices. Note that a tax cut is a one-off change: properly managed it ought not to lead to persistently higher inflation. The catch now is that the tax cut is being implemented at a time of an already strong cycle and, as such, the inflationary outcome is uncertain.

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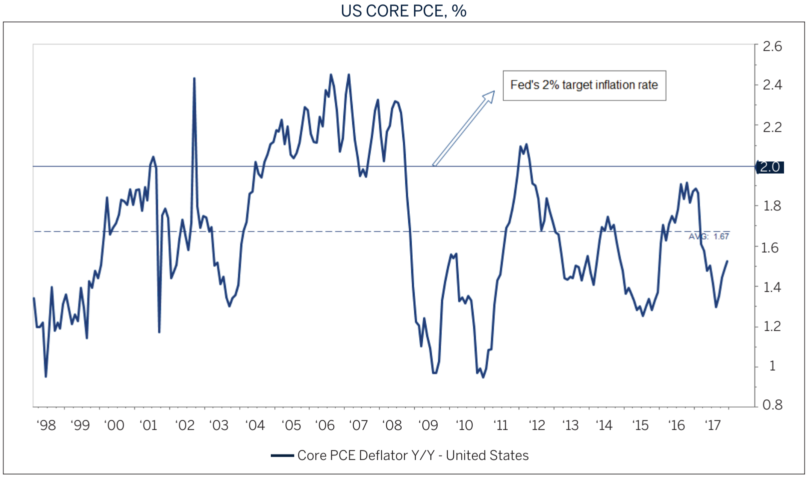
The Federal Reserve Bank of San Francisco recently released a paper on US inflation and argued that underlying price data reveals that low inflation is the result of categories of prices that are relatively insensitive to overall economic conditions. This trend is not expected to change. The research shows that "procyclical inflation has steadily returned to its pre-recession level, in line with improvements in economic conditions and a tightening labor market." In other words, inflation is mostly behaving normally, but categories such as healthcare are expected to be sustainably lower than in the past.

US CORE PCE, %



Source: Factset Research System

"Although yields are still low by historical standards, a sharp movement nonetheless acts as a headwind to equity valuations."

Even so, US rates have moved higher, as they need to. The US 10-year bond yield has increased from 1.4% in 2016, to 2% in September 2017, and is now nearly 3%. Although yields are still low by historical standards, a sharp movement nonetheless acts as a headwind to equity valuations, and makes income earning assets such as bonds and cash relatively more attractive than before. Still, buoyant economies are unlikely to be derailed until interest rates are much higher than they are now, but high market valuations mean asset prices are very sensitive to changes.

Credit risk for private sector companies is measured by the additional required rate of return or 'spread' over the rate investors can earn on US treasuries. They are a useful gauge of risk appetite. Spreads usually narrow when companies are doing well, and economies are growing. Spreads widen when the 'growth' outlook deteriorates because corporate cash flow becomes less certain. Credit spreads are now at historically low levels (expensive), but reacted only slightly to the correction in global equity markets. This is an indication that market participants are not overly concerned about the near-term outlook for growth and profitability of companies.

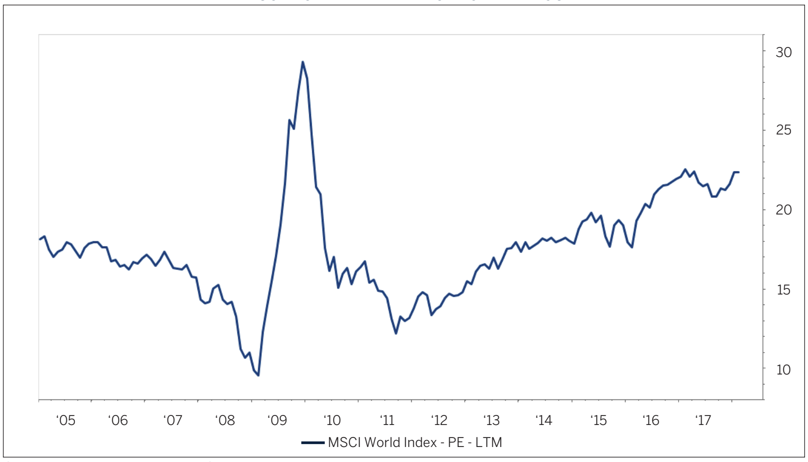
"Although valuations can remain elevated for a period, the margin of safety has diminished, which will make the asset class more vulnerable."

So, if investors are not overly concerned about the path for economic growth and inflation, what has caused the meaningful sell-off in global equities?

The answer is a combination of factors, but can primarily be ascribed to the recalibration of inflationary expectations at a time of stretched equity valuations. Equity markets have experienced complacency and an unusually long period of positive monthly returns. Given the lack of alternatives during a prolonged period of abnormally low interest rates and an improved growth outlook, investors have been willing to take on more risk, by paying a higher price for each level of earnings.

Although valuations can remain elevated for a period, the margin of safety has diminished, which will make the asset class more vulnerable to unexpected events, such as a sharp increase in interest rates/inflation or weaker than expected growth.

MSCI WORLD INDEX - PRICE TO EARNINGS



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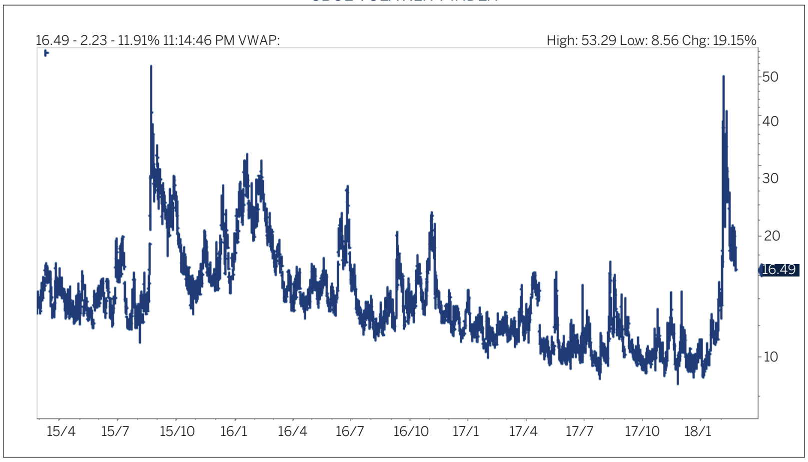
"A necessary and long overdue correction was amplified by investors and market makers being forced to unwind their highly-geared, volatility-linked derivative positions very fast."

One illustration of how complacency has become embedded in financial markets is a measure called the "VIX" index. The index measures the US stock market's expectation of future volatility and has been trending lower for a prolonged period. Lower levels of volatility are usually associated with higher valuations. Investors, including the public and a few pension funds, have literally been betting on lower levels of volatility using complicated derivative products. During the past two years this trade has paid handsome dividends for investors, because there has been a persistent trend decline in volatility. However, this all came to an abrupt end when confronted with higher wage growth, higher US inflation and adverse commentary from the European Central Bank. A necessary and long overdue correction was amplified by investors and market makers being forced to unwind their highly-geared, volatility-linked derivative positions very fast.

CBOE VOLATILITY INDEX



Source: Factset Research System

"Equities have recovered from their lows as investors turned their attention to favourable economic fundamentals."

Equities have recovered from their lows as investors turned their attention to favourable economic fundamentals, but the correction has shown that the combination of less easy monetary policy and high valuations leaves the door open for volatility to return in the months ahead.

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“This was a warning that “easy-money” conditions have created risk-chasing behaviour that may no longer be sustainable as those conditions change.”

Conclusion

The global economic backdrop is strong and economists have been revising their forecasts upwards. Global inflation is expected to move higher as economies grow and labour markets tighten, but most commentators believe that future inflation will remain in check and in line with long-term trends, allowing central banks to gradually remove excess liquidity by increasing interest rates to more normalised levels.

Nevertheless, we think it would be foolish to ignore the recent correction, or to write it off to the excesses of a few traders in obscure corners of the market. The inflation and wage numbers that supposedly triggered the event were a surprise, but within the range of possible outcomes embedded in market expectations. The response – inflation is under control, so the correction must be market irrationality - could be misleading: what the Fed does is usually reactive. Markets are ahead of the Fed, and the longer it takes the imbalances to build, the larger the potential dislocation if there is a real surprise. So, investors need to treat the February wobble as a warning sign: don’t write it off as irrational. This was a warning that “easy-money” conditions have created risk-chasing behaviour that may no longer be sustainable as those conditions change. In addition, the fallout from excess in obscure assets can have significant effects on much larger asset classes.

Diversification is essential, and the recent bout of volatility was a timely reminder for investors to keep a close eye on valuation, and to ensure that they stay well within their defined risk parameters.

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Asset Classes

Equities	Overweight
Fixed Interest	Underweight
Real Return	Overweight
Cash	Underweight

Equities

Consumer Staples	Neutral
Consumer Discretionary	Overweight
Energy	Underweight
Financials	Neutral
Technology	Overweight
Healthcare	Underweight
Industrials	Overweight

- With 2017 being the fifth calmest year on record it is unsurprising that 2018 has started with the 10th highest spike in volatility since 1986. However the short and violent bout of volatility seen in late January/ early February, triggered by an 'inflation scare' has quickly subsided. Markets have already regained half of what they had lost as **economic and corporate fundamentals remain favourable** and suggest that stock prices will, subject to increased volatility, move higher as the year progresses.

- When to de-risk is always a difficult call, especially when there is the ongoing support of synchronised global economic growth and strong positive corporate earnings momentum. However, with equity valuations in the top 10 percentile, relative to the last five years, the economic expansion now long in the tooth and the **headwinds of higher interest rates and bond yields in the year ahead,** the less favourable risk reward ratio is pushing us to move our equity weight to neutral.

- **Bond markets** are negatively reacting to the prospect of higher inflationary forces and increasing interest rates and therefore we remain underweight this asset class in all our multi-asset strategies and defensively positioned via shorter-dated issues.

- February saw a huge 'wake up' call for complacent investors when volatility alarmingly increased following the publication of the monthly US employment report. Even though there were surprises within the report it was hardly deserving of such market concern and in all probability there were other more technical reasons for the sharp 10% fall in US equities. It is interesting to note that February saw more daily one per cent moves in the Dow Jones index then the whole of 2017. Whilst markets may calm down, we still see **2018 volatility being at consistently higher levels than last year.**

- For some time we have recognised that it is more challenging to find US stocks that appeal in terms of fundamental valuation. This has led us to selectively introduce more cyclicality into our portfolios via positions reflecting better relative value such as **Brenntag, Illinois Tool Works** and the US banks.

- Additional focus has also been addressed to opportunities outside of the US, including Continental Europe where we introduced exposure to **Booking Holdings** (previously Priceline and traded in the US) and more recently added **Banco Santander** to our bank exposure. Both of these give us significant European exposure but the latter plays to the recovery in Latin America and Southern Europe as well.

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Fixed Income

G7 Government	Underweight
Index-Linked (US Government)	Overweight
Investment Grade – Supranational	Overweight
Investment Grade – Corporate	Overweight

- **US government bond yields** continued to climb in February with the ten-year benchmark edging ever closer to the much hyped psychological level of 3%. We expect continued upward pressure on global bond yields in the months ahead and accordingly, all fixed income strategies remain defensively positioned.
- We see numerous signs of mounting inflationary pressures in the US, most notably from the recent jump in average earnings. We have maintained our exposure to the **US index-linked** market which has materially outperformed the broader conventional market since mid-2017.
- Global central banks continue to step away from the ultra-accommodative policies that drove yields to unsustainably low (and often negative) levels. We are particularly concerned about the **Eurozone bond market** where we expect yields to correct significantly as the ECB continue to change their monetary course in the quarters ahead.

Currencies / Interest Rates

RECOMMENDATION - INTEREST RATES			
		CURRENT	DIRECTION
US Dollar	Overweight	1.50%	↑
Sterling	Neutral	0.50%	→ ↑
Euro	Underweight	0.00%	→

- The negative trend in the **US dollar** took a pause in February with the currency rising over 1.5% on a trade-weighted basis. We continue to watch the currency closely with the intention of reducing the long held overweight position in favour of the Euro where we see improving long term fundamentals.
- Whilst upholding our long term positive outlook, we remain of the opinion that the strong appreciation of the **Euro** (versus the US dollar) over recent quarters was due either a pause or short-term retracement. Real returns in Euro cash or bonds remain deeply negative and may continue to act as a barrier to more short-term strength. We are waiting to allocate to the Euro, at the expense of US dollars, at more attractive levels and are monitoring the pair closely.

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